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Financial disclosure a matter for trusts

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Regulators, credit analysts, and investor advocates continue to sound the alarm on financial reporting by income trusts.

Two recent reports draw attention to the information — or lack of it — that is made public by these popular investments. The Canadian market is now home to more than 140 income trusts — investments that are designed to spin off a regular cash distribution to unitholders. As a whole, the industry is worth some $120 billion. To date, about three dozen trusts have cut or suspended their payouts, leaving investors stranded.

The Canadian Securities Administrators, an umbrella group of provincial securities regulators, issued its latest report in August. It examined financial reporting and disclosure by a small sample of trusts — just 45 of them — but found some big problems.

In total, 84 per cent of the issuers didn't meet required standards for financial disclosure.

According to the report, 31 agreed to make improvements in future communications to investors. Another seven were actually required to refile disclosure documents. Just seven "had no identifiable deficiencies," the CSA found.

The crux of the problem lies with what's known as "distributable cash," or how much cash the trust has available to pay the monthly or quarterly yields it has promised to unitholders.

There's no standard definition — nor is this figure included in annual audits. That can make it hard to figure out just how the trust generates its cash flow, and how reliable it is.

"You have this distributable cash figure that not only does everybody calculate it differently, but it's not an audited number, and there's no link between it and any of the audited financials," said mutual-fund industry expert Dan Hallett.

In fact, trusts don't even use the same term to talk about their cash flow. In a two-part report issued by Standard & Poor's in January, the credit-rating agency looked at 40 trusts and found 19 different names used for the concept "generating and making cash available for distribution."

Troubles at some income trusts have made headlines. Auditors first alleged in 2003 that Atlas Cold Storage was improperly booking expenses as capital assets, an accounting tactic that seemed to improve its earnings and cash flow.

Heating Oil Partners Income fund stunned investors when it filed for bankruptcy protection in September 2005; and units of FMF Capital Group plummeted from more than $10 apiece to less than $1 in November 2005 when it suspended distributions.

When it comes to finding a solution, some look to the regulators.

But despite its findings, the CSA didn't bring sanctions against any trusts.

Investor advocate and independent analyst Diane Urquhart believes the CSA has breached its duty to investors — particularly seniors — by not sanctioning trusts or instituting new regulations.

Hallett agrees that regulators need to take a closer look.

"I think something should be done, whether it's coming up with a standard definition or making it an audited figure," he said. "Either would be better than the status quo."

Kevin Hibbert, primary credit analyst and co-author of the S&P report on income trusts, agrees. "I think it really comes down to the regulators taking a more proactive response to this."

If you're an investor who holds income trusts, do some homework on the risks involved. The Small Investor Protection Association website (http://www.sipa.ca) has a whole section on income trusts.

Wade through the financial statements to get a handle on how the trust generates cash and how it plans to consistently pay out what it has promised.

Most investors seem to be pretty familiar with concepts like earnings per share and price/earnings ratios, Hibbert said. The same is needed for accounting. "We don't have to all be chartered accountants, but we should at least try to get the accounting knowledge up to snuff as compared to the market metrics."

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